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Advisory Commission Releases CPI Report Today

Republican Reminders on CPI

The Advisory Commission To Study the Consumer Price Index (CPI) released its report today. Its findings are that the CPI is overstated by approximately 1.1 percentage points.

As is usually the case with issues that foment the appointment of a commission, CPI has a long contentious history that Senators would do well to remember. Congress should also remember that this issue is closely tied with entitlement program spending in general and Social Security spending in particular, as well as indexing of income tax brackets. President Clinton deliberately demagogued the entitlement spending issue in the last election, claiming "spending cuts," when in fact entitlement spending went up under every budget proposal that Congress passed in the 104th Congress.

Given this history, if CPI adjustment is to be addressed responsibly, it is President Clinton who — in his forthcoming budget, his Council of Economic Advisers' Economic Report, or through technical, nonlegislative adjustments by his Bureau of Labor Statistics (BLS) — must take the first step.

Overview of CPI

Simply, the CPI is a formulaic adjustment to ensure that federal programs are held at a constant level in economic terms by estimating the cost of a fixed-market basket of goods and services. While this may seem theoretically straightforward, it involves numerous inherent problems as the advisory commission demonstrates. Among these are the fact that the CPI is not a cost-of-living index *per se* because it essentially eliminates the dynamic quality of change that a true cost-of-living measure would entail. Specifically, the CPI contains numerous problems such as **substitution** (the changing mix of products), **outlet** (the changing way these products are purchased), **quality change** (the improvement of quality over time), and **new product** (when new products are introduced) biases.

In practice, the CPI has meant taking into account inflation's effect and adjusting federal programs accordingly, in order that the value of the particular benefit not be eroded over time.

CPI has a particular impact in the area of federal entitlements and — because these are a large and growing portion of the federal government's expenditures — on the federal budget.

It is widely held that the method for calculating the effects of inflation has for decades overstated inflation's effects. Federal Reserve Board Chairman Alan Greenspan's opinion that the CPI may be overestimating inflation's impact by anywhere from 0.5 to 1.5 percentage points is in line with that of many economists. The advisory commission states that "the range of plausible values is 0.8 to 1.6 percentage points per year" for the overstatement and that its "best estimate of the size of the upward bias" is 1.1 percentage points. Their recommended adjustment is therefore consistent with other estimates.

Because the CPI is intended to take into account changes in the impact of inflation impact, it is periodically revised by the BLS. The two most recent BLS methodological revisions have been: 1) a -0.24 percentage-point adjustment this summer to eliminate a methodological estimating problem; and 2) a -0.30 percentage-point revision that will take place in 1998 for the most recent inflation impact.

CPI in the Budget Debate

The effect of an adjustment in the CPI of the magnitude recommended by the advisory commission demonstrates the magnitude of the issue's impact on the budget. According to the Congressional Budget Office (CBO), a 1.0 percentage-point downward revision would result in a reduction in federal outlays of $144.8 billion over the 1996-2002 period. Because of the compounding effect, the impact over time is even more dramatic — $308 billion over the 1996-2005 period.

Nor is the effect limited to outlays. Because the tax code is also indexed for inflation (in 1981 for income thresholds, deduction limitations, tax brackets, etc.), a downward 1.0 percentage-point revision would have the effect of increasing revenues by $98 billion over the 1996-2002 period and by $206.8 billion over 1996-2005. Furthermore, because of these large budgetary effects, the government's need for borrowing would greatly diminish, thus saving an additional $38.6 billion (1996-2002) and $119.7 billion (1996-2005). All told, a 1.0 percentage-point downward revision in the CPI would reduce the deficit by $242.8 billion over 1996-2002 and by $634.5 billion over 1996-2005.

The full 1.1percentage-point revision would of course be slightly more substantial. As the report points out, *"cumulatively . . . it adds up to a sizeable difference, 14 percent over a dozen years."* By continuing to overstate the level of inflation by 1.1 percentage points, the deficit will be $148 billion higher in 2006; $691 billion in deficit spending will take place between now and that time. *"The bias alone would be the fourth largest federal program, after social security, health care and defense. By 2008, these totals reach $202 billion and $1.07 trillion, respectively"* [Final Report, 12/4/96, p. ii].

While a downward CPI revision was not proposed in either Congress's or the President's budgets in the 104th Congress, it was included in the budget proposed by Senators Chafee (R-RI) and Breaux (D-LA) that was rejected 46-53 (with 22 Republicans and 24 Democrats voting in favor, Roll Call Vote 150, 5/23/96). Their CPI revision would have saved $110 billion over seven years — $63 billion in reduced spending and $47 billion in increased revenues.

Policy Implications

Four policy implications should be considered regarding the CPI adjustment issue: 1) What would a revision mean for the particular programs? 2) What would a revision mean for general fiscal policy? 3) What would a revision mean for the economy? and 4) Are these consistent with past policy?

First, while a downward CPI revision would result in program spending being lower than it otherwise would have been, it would not mean a cut in any sense. Spending would increase in a nominal sense and, because a CPI revision would be based on the best estimates of inflation's effects, the resulting spending increase would more closely match the real economic cost of the previous year's levels. The report also notes that no group in particular would be adversely affected by such a revision:

> *"Some have suggested that different groups in the population are likely to have faster or slower growth in their cost of living than recorded by changes in the CPI. We find no compelling evidence of this to date..."* [Report, p. 71]

Second, a revision obviously would have dramatic downward effects on the budget deficit. Interest rates would fall as a result of less federal borrowing, thus reducing costs to the private sector as well. Third, however, the overall economic effect would not be as beneficial as was that of the 1995 Balanced Budget Act that President Clinton vetoed or the budget resolution passed by Congress last year. The reason lies in the tax increase aspect of a CPI adjustment.

A CPI revision's impact is split roughly 60-40 between spending cuts and revenue increases. These revenue increases for the government are revenue reduction for the private sector. In contrast to specific corporate loophole closings that can distort the economy, these revision's revenues would be raised on an across-the-board basis. While the private sector would benefit from reduced interest costs, it would also suffer from reduced after-tax income. Offset tax cuts would be needed in order to negate these adverse economic effects.

Finally, while a CPI revision is consistent with a responsible fiscal policy, it is not entirely consistent with the approach taken in the last Congress to achieve it. The deficit can be reduced in two ways: Federal spending's rate of growth can be allowed to come into line with federal revenues or federal revenues can be brought into line with federal spending. The first way is preferable economically because it would leave more resources where they can be most productively used. This is the approach Congress took over the last two years.

A CPI revision would affect both the spending and the revenue side of the equation. However, the overall effect would be to leave federal spending and taxes higher than they would have been under any of the approaches passed in the 104th Congress. Furthermore, the 104th Congress specifically exempted Social Security from any policy changes in its balanced budget plans.

Conclusion: The President's Responsibility to Act

A CPI revision would not have adverse real economic effects on the spending programs affected. It would have positive real effects on the federal deficit. Only in the case of its economic effects is the picture not so bright.

Congress should receive the advisory commission's report with a grain of salt. Congress has already acted responsibly — programmatically, fiscally, and economically — over the last two years. Had its plans been accepted, the budget would have balanced in 2002.

In contrast, it is the White House that has acted programmatically, fiscally, and economically irresponsibly over the last two years. It has opposed every legislative alternative that Congress has offered that would have led to a balanced budget — whether as a specific balanced budget bill or as a Balanced Budget Amendment to the Constitution. The legislative approach has not and will not be successful until the White House decides that it will act responsibly.

And so, even if a CPI revision were deemed to be the proper course, a unilateral legislative approach by Congress is not the way to implement it. The President's past actions and present statements serve to indicate that the only way to revise the CPI is through technical changes in its calculation.

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